3 Economic Worries That Needn't Be

By Jason Stipp| 3-28-2012 1:00 PM

Jason Stipp: I'm Jason Stipp for Morningstar. As the immediate crisis in Europe has abated a bit, market watchers have had to look elsewhere for reasons to wring their hands, but Morningstar's Bob Johnson says at least three of those handwringing reasons might not be so much to worry about, at least right now. He is here with me to explain.

Thanks for joining me, Bob.

Bob Johnson: Great to be here.

Stipp: There are three things that, over the last few weeks, have caused the market some worry, and I'd like to take them one by one.

The first one, especially domestically, that has caused a lot of worry, are gas prices, and we know that high gas prices can take a chunk out of consumers' wallets. But you say maybe this isn't such a huge thing to worry about, but you also talk a lot about the consumer's spending power, too. So why shouldn't we be *horribly* worried about gas prices at their current levels?

Johnson: Gasoline overall for consumers represents about 3.7% of their spending. So it's not huge, but it's a much big portion obviously the further you go down the income scale, because everybody uses about the same amount of gasoline. So it's is a much higher proportion of lower-income people's income. So that's clearly a concern, but at 3.7%, it's not a huge number.

And actually as prices have gone up, consumers have actually voted with their feet, so to speak. They are walking more, they're doing something more, because gasoline consumption has been way down on a per-capita basis over the last three or four years as prices have risen. So, as prices move up, they are avoiding gas, and there is some talk today even in *The Wall Street Journal* that maybe some of the refiners are leaving the market because they are afraid they can't raise prices high enough to compensate for doing the refining process.

Stipp: And you mentioned that the percentage of income that gas takes obviously is a bigger percentage for lower income folks, but not so much of a percentage of the higher income folks' household income. Does that also play into the fact that the higher income folks have been driving a lot of the consumer recovery in your mind?

Johnson: They sure have. You have seen the high-end really driving things, and

with the stock market being up the last two quarters in the 5%-10% range, that's certainly made them do better, and we have seen a couple of the luxury goods manufacturers report better-than-expected numbers. So, after some fears last summer that the high end was through when the market was so weak, I think now the high-end consumer is looking good again.

And just to add something on the numbers with the gasoline: I think that what does matter, and matters a lot, is inflation. It is what kills every last [recovery], and the danger point is 4% year-over-year inflation. And last year, we got deadly close to that, and it did slow consumer spending. Gasoline last year was part of that, but last year we [also] had food prices going through the roof at the same time. And because of the tsunami, the carmakers were running prices through the roof, and used car prices were going very high.

So, you had that combination of three different things causing inflation to spike. So, people might say, "I remember gasoline prices were high last spring, therefore we're dead," but really, there were three things going on last year, not just one.

Stipp: So, inflation definitely very important, but you have to look at the overall inflation picture. Don't necessarily get too worried about one of those inflation components going up a bit.

The second thing, Bob, that has also caused a lot of worry over the last few weeks is China potentially slowing down. We have seen some data out of China that shows some moderation there, but you say that we shouldn't, at least as an economy, be too horribly worried about China slowing down, and maybe we should be a little happy about it. Why is that?

Johnson: China, by itself, represents a fairly small portion of U.S. GDP, maybe something in the 1% to 2% range. And a lot of that is soybeans, and it's an agricultural commodity that China will probably continue to buy, good times or bad times. So, I am not so worried about the number, because it's not like China is going to zero, and it's not like they are that big a portion to start with. So, I am not terribly concerned about them, and even the knock-on effects aren't as bad as one might think.

Stipp: So, if China does slow down a bit, that could also take some pressure off commodity prices as well, right?

Johnson: Absolutely. That's the silver lining here. The little bit we ship to China doesn't make much difference to our GDP, but if it boosts commodity prices 5%, now that's a big deal to the U.S. consumer, and I think really the boost in commodity

prices last year was what killed some of the retail spending numbers in the middle of the year. So there is a real silver lining to China slowing down a bit, as long as it isn't too much.

Stipp: And the other thing is, there is an important distinction here between the effects potentially on the economy and the effects that we are seeing on certain companies of a China slowdown--like Caterpillar, for example, will take a hit if China really slows down a lot. What are the distinctions there that we need to be aware of when we are thinking about China?

Johnson: A lot of companies sell goods to China, and many of those goods are manufactured or provided overseas. So they affect other countries' GDPs and not ours, but it does still affect the corporate earnings. So it's a big deal to some companies that get a substantial portion of their sales out of China, and maybe manufacturing in China or Vietnam or someplace else overseas. So, it can have a big effect on companies, and the S&P earnings were certainly helped by growth in China, and now they're probably going to be hurt by slowing in China.

Stipp: So important to remember that as companies become more global, their results might not necessarily be tied to the U.S. economy because they have these operations all around the world.

Johnson: Exactly.

Stipp: The last thing, Bob, that was a worry a couple of weeks ago maybe not as much of a worry right now, but I think is still on investors' minds, is interest rates, and the fact that if those go up, that could have a negative impact on the economy. What's your take on rates and should that be something that's on our radars right now as a worry sign?

Johnson: You've always got to keep a little bit of an eye on rates, and the reason everybody got so scared is over the last two weeks, up until Monday or so, rates had gone from about 2% on the 10-year U.S. bond to 2.4% in a very short period of time, looking like they are on their way to 3%.

And this week Bernanke, the Fed chairman, threw cold water on that a little bit. He said, that he thought the economy wasn't necessarily strong enough and that all his tools in his arsenal were still at his disposal, and he would be very willing to use them the moment he saw any slowing. And so I think that maybe took a little of that worry off the table, but even still, I'm not terribly worried about rates for a number of reasons.

Stipp: If rates did tick up, is there a level where you start to get a little bit worried?

Johnson: Well, I suppose if we got the 10-year treasury back to 3.5%-4%, I'd be worried. I think 3% I can still live with.

But remember that there are offsets. Retiree income has been a horribly big hole in the personal income number, and in individuals' actual spending habits, as rates have collapsed and people clamor about very low CD numbers. So, there are reasons that people are concerned. It has wrecked a lot of pension plans and forced bigger pension contributions as the assumptions have come in. And low rates have made people feel complacent, like "I don't have to do anything. I think rates are going to stay lower forever." So, I think the fact that they move up is not a total disaster, and even in the housing market, some people say, "Well, gee, if rates are going up a percent, it's going to kill the market. Not a chance. Not a chance."

Stipp: In fact, it might light a fire under some of those fence-sitters to go out and get that mortgage right now, just in case rates would go even higher in the future.

Johnson: It's a combination of what people think is going to happen to the rents, what they think is going to happen to housing prices, and what the rate is on the mortgage. Right now, I will tell you, affordability is not stopping people from buying houses; it's appraisals on homes, it's tight lending standards at banks, it's a fear that housing prices have another 5% or 10% down leg left in them. That's what's stopping the housing market. Rates could go up considerably and people could certainly afford a higher mortgage rate.

Stipp: All right, Bob, as always very valuable context and perspective on the U.S. economy. Thanks for joining me today.

Johnson: Great to be here.

Stipp: For Morningstar, I'm Jason Stipp. Thanks for watching.